GOVERNMENTAL ACCOUNTING

Fund Accounting:

Statute indicates resources which a county is permitted to receive and expressly or implicitly states the purposes for which those resources may be used. The accounting system used by a county should provide for legal compliance; that is, resources are received and spent according to law. For this reason, counties have evolved a means of indicating legal compliance by use of "fund accounting."

The Governmental Accounting Standards Board has defined the term "fund" as follows:

> A fund is a fiscal and accounting entity with a self-balancing set of accounts recording cash and other financial resources, together with all related liabilities and residual equities or balances, and changes therein, which are segregated for the purpose of carrying on specific activities or attaining certain objectives in accordance with special regulations, restrictions, or limitations.

The diverse nature of a county's operations and the necessity of determining legal compliance preclude a single set of accounts for recording and summarizing all the financial transactions. Instead, the required accounts are organized on the basis of funds, each of which is completely independent of any other. Each fund must be so accounted for that the identity of its resources, obligations, revenues, expenditures, and fund equities is continually maintained. These purposes are accomplished by providing a complete self-balancing set of accounts for each fund which shows its assets, liabilities, reserves, fund balances or retained earnings, revenues and expenditures/expenses.

An account is defined as a formal record of a particular type of transaction. A group of accounts comprise a ledger. Similarly, a group of accounts consisting of all accounts required to describe the financial condition and results of an entity operation comprise a general ledger.

In the private-sector, even complex businesses generally are presented in external financial reports as a single, unitary entity. For example, data from a parent company are merged with data from that company's subsidiaries to create a single, consolidated entity for financial reporting purposes. State and Local governments, on the other hand, have prepared combined (rather than consolidated) financial statements that focus on groups of related funds (fund types and account groups), rather than on the government as a whole. Fund accounting for state and local governments has its historical roots in the desire of state and local governments to ensure and demonstrate legal compliance with internal (budgetary) and external limitations (grantors and creditors) placed upon the use of resources.

CHANGES IN FUND STRUCTURE AND THE USE OF FUNDS

The changes in the fund structure required by GASB 34 are summarized in the table below. The funds that were eliminated or added have been referenced in the table below.

SUMMARY OF CHANGES IN FUND STRUCTURE

Current Governmental Financial Reporting Model

Governmental Funds				Proprietary Funds		Fiduciary Funds Trust and Agency Funds				
General Fund	Special Revenue Funds	Debt Service Funds	Capital Projects Funds	Enterprise Funds	Internal Service Funds	Expendable Trust Funds	Nonexpendable Trust Funds	Pension Trust Funds	Investment Trust Funds	Agency Funds
						(Eliminated)	*(Eliminated)*			

New Governmental Financial Reporting Model

Governmental Funds					Proprietary Funds		Fiduciary Funds				
General Fund	Special Revenue Funds	Debt Service Funds	Capital Projects Funds	Permanent Funds	Enterprise Funds	Internal Service Funds	Private-Purpose Trust Funds	Pension (& Other Employee Benefits) Trust Funds	Investment Trust Funds	Agency Funds
				(Added)			*(Added)*	*(Added)*		

As you can see in the table above there were no dramatic changes in the governmental or proprietary funds, however, there will be significant changes in the fiduciary funds – trust and agency funds.

The GASB feared that the inclusion of the fiduciary funds resources that are not available to support a government's programs within a set of government-wide financial statements might be misunderstood by the financial statement users. Accordingly, fiduciary funds (and fiduciary-type component units) will be excluded from the new government-wide financial statements required by GASB 34. GASB 34 will allow fiduciary funds to be used only to report assets that *"cannot be used to support the government's own programs".* As a result of this change, many activities currently reported in fiduciary funds, particularly in expendable trust funds, now will be reported in some other fund type. In many cases, the new location of reporting such activities will be one of the governmental funds (general fund, special revenue funds).

GASB Statement No. 34 alters this existing fiduciary fund structure in four important ways: First, the new reporting model eliminates the trust and agency fund type, thereby elevating the various components of this fund type to fund-type status in their own right. Second, the new reporting model eliminates both the expendable and nonexpendable trust fund types. Third, GASB Statement No. 34 creates a new "private-purpose trust funds" fund type. Finally, the pension trust fund type is expanded to embrace other employee benefits as well as pensions.

The new fiduciary fund types consist of the following:

? Pension (and other employee benefit) trust funds – This fund type is used to report resources that are required to be held in trust for the members and beneficiaries of defined benefit pension plans, defined contribution plans, other post-employment benefit plans, or other employee benefit plans. If the noncertificated staff of a municipality do not participate in the South Dakota Retirement System, and if the governing board elected, prior to July 1, 1974, to provide a retirement plan for these employees, this fund type would be used to report the pension fund.

- Investment trust funds – This fund type is used to report the external portion of investment pools reported by the sponsoring government, as required by GASB Statement No. 31, paragraph 18.

- Private-purpose trust funds - This fund type is used to report all trust arrangements under which the principal and income benefit private individuals, private organizations, or other governments.

- Agency funds – This fund type is used to report resources held by the reporting government in a purely custodial capacity (assets equal liabilities). Agency funds typically involve only the receipt, temporary investment, and remittance of fiduciary resources to individuals, private organizations, or other governments. Section 125 medical and daycare escrows would be an example of agency funds.

Under the current reporting model fiduciary funds do not all present the same basic financial statements. Under the new governmental financial reporting model, all fiduciary funds will report the same two basic financial statements: a Statement of Fiduciary Net Assets and a Statement of Changes in Fiduciary Net Assts. This change is the natural result of the elimination of the expendable and nonexpendable trust fund categories.

INTERNAL SERVICE FUNDS – As a general rule, the assets and liabilities of internal service funds will be eliminated, for the most part, in the process of consolidation. Any remaining balances that are not eliminated normally will be reported in the "governmental activities" column of the statement of net assets (rather than the "business-type activities" column), even though internal service funds are proprietary funds rather than governmental funds. The GASB reasons that this treatment is appropriate because the activities accounted for in internal service funds are usually more governmental than business-type in nature. (self insurance coverage for employees of governmental activities). Conversely, in situations where enterprise funds are, in fact, the predominant participants in internal service fund activities, residual balances should be reported in the "business-type activities" column of the government-wide statement of net assets.

A key goal of consolidating internal service funds is to eliminate <u>duplication</u>. The revenues and expenses between the internal service fund and the entity fund it serves should not double up on reporting the revenues and expenses. For example, the charge to a General Fund function for health insurance and the payment of a claim from the internal service fund would essentially double up on reporting the same expenditure.

For purposes of consolidation, it is presumed that an internal service fund operates on a strictly break-even basis within the primary government. Accordingly, any profit on internal activity is presumed to indicate that participating functions have been overcharged. Likewise, any loss on internal activity is presumed to indicate that participating functions have been undercharged. Therefore, consolidation is accomplished by reducing (if there is a profit) or increasing (if there is a loss) the amount of expense reported in the participating functions.

The GASB 34 also created a fifth governmental fund type, to be known as a "Permanent Fund". The role of the permanent fund is "to report resources that are legally restricted to the extent that only earnings, and not principal, may be used for purposes that support the reporting government's programs – that is, for the benefit of the government or its citizenry". It is anticipated that this new fund type will be used to report a number of activities currently reported in nonexpendable trust funds, which will themselves be eliminated with the advent of GASB Statement No. 34.

Another significant change affects the reporting of the General Fixed Asset Account Group and the General Long-term Debt Account Group. Governmental funds were designed to report sources and uses of current financial resources. Because capital assets and most long-term obligations represent neither, governments traditionally have been required to present account groups to report capital assets and long-term obligations associated with activities reported in their governmental funds. However, under the new financial reporting model, the assets and liabilities currently reported in the two account groups will henceforth appear on the face of the government-wide financial statements.

Along with the change in reporting of the general fixed assets account group comes another change required by GASB 34, that of capital asset depreciation and infrastructure reporting. Accountants have used the term "infrastructure" to refer to assets that are immovable and of value only to the government (roads, bridges, dams). Under the current financial reporting model, state or local governments have not been required to report general infrastructure assets in their financial statements. However, the economic resources measurement focus and the accrual basis of accounting will be used in the future to report governmental activities in the government-wide financial statements. Under GASB 34 governments are to capitalize general infrastructure at their historical cost or estimated historical cost. Governments are required to capitalize all future infrastructure acquisitions, renovations, restorations, or improvements from the date of implementation of GASB 34 (prospective reporting). Different effective dates have been provided, however, for the retroactive reporting of infrastructure assets as follows:

> Phase 1 –Governments with total revenues of $100 million or more will be required to implement the retroactive reporting of infrastructure assets for fiscal years beginning July 1, 2005
>
> Phase 2 –Governments with total revenues of $10 million or more, but less than $100 million, will be required to implement the retroactive reporting of infrastructure assets for fiscal years beginning July 1, 2006
>
> Governments with total revenues of less than $10 million are exempt from the requirement to report their general infrastructure assets retroactively.

Although state and local governments traditionally have reported general capital assets in their financial statements, they have not depreciated those assets. Once again, the move to the economic resources measurement focus and the accrual basis of accounting will substantially change traditional practice. Governments will be required under the new financial reporting model to report depreciation expense for all of their capital assets, including general infrastructure assets discussed above.

SECTION I--GOVERNMENTAL ACCOUNTING

Classification of Funds and **Self Balancing Accounts**:

Funds are classified according to the source of revenue and the type of activities which they finance. Funds of a similar nature are classified according to fund groups. The following classification contains the appropriate fund groups, types, and self-balancing accounts:

Governmental Funds:
100 - General Fund
200 - Special Revenue Funds
300 - Capital Projects Funds
400 - Debt Service Funds
450 - Permanent

Proprietary Funds:
500 - Enterprise Funds
600 - Internal Service Funds

Fiduciary Funds:
710 - Private Purpose Trust Funds
720 - 779 - Agency Funds
780 - Pension (and other Employee Benefit) Trust
790 - Investment Trust Funds

Self-Balancing Accounts:
800 - General **Capital Assets**
900 - General Long-Term **Liabilities**

DEFINITIONS OF FUNDS

Governmental Fund Types

100 **General Fund** - to account for all financial resources except those required to be accounted for in another fund.

200 **Special Revenue Funds** - to account for the proceeds of specific revenue sources (other than major capital projects) that are legally restricted to expenditures for specified purposes. When grants require a separate fund, a special revenue fund should be established for each grant.

300 **Capital Projects Funds** - to account for financial resources to be used for the acquisition or construction of major capital facilities (other than those financed by proprietary funds **or in trust funds for individuals, private organizations or other governments.) Capital outlays financed from general obligation bond proceeds should be accounted for through a capital projects fund.**

400 **Debt Service Funds** - to account for the accumulation of resources for, and the payment of, general long-term debt principal and interest.

450 Permanent Funds - To account for resources that are legally restricted to the extent that only earnings, and not principal, may be used for purposes that support the reporting government's programs - that is for the benefit of the government or its citizenry.

Proprietary Fund Types

500 **Enterprise Funds** - to account for operations (a) that are financed and operated in a manner similar to private business enterprises - where the intent of the governing body is that the costs (expenses, including depreciation) of providing goods or services to the general public on a continuing basis be financed or recovered primarily through user charges; or (b) where the governing body has decided that periodic determination of revenue earned, expenses incurred, and/or net income is appropriate for capital maintenance, public policy, management control, accountability, or other purposes.

600 **Internal Service Funds** - to account for the financing of goods or services provided by one department or agency to other departments or agencies of the governmental unit, or to other governmental units, on a cost reimbursement basis.

Fiduciary Fund Types

700 **Fiduciary Fund Types -** are used to account for assets held by a governmental unit in a trustee capacity or as an agent for individuals, private organizations, other governmental units, and/or other funds. These include:

710 Private Purpose Trust Funds - To account for trust arrangements under which principal and income benefit individuals, private organizations, or other governments. (This type of fund is used to report escheat property.)

720 Agency Funds - To account for resources held by the reporting government in a purely custodial capacity (assets equal liabilities). Agency funds involve only the receipt, temporary investment, and remittance of fiduciary resources to individuals, private organizations, or other governments.

780 Pension (and other employee benefit) Trust Funds - To account for resources that are required to be held in trust for the members and beneficiaries of defined benefit pension plans, defined contribution plans, other post-employment benefit plans, or other employee benefit plans.

790 Investment Trust Funds - To account for the external portion of investment pools reported by the sponsoring government, as required by GASB Statement 31, paragraph 18.

800 General Capital Assets - capital assets of the government that are not specifically related to activities reported In proprietary or fiduciary funds. General capital

assets are associated with and generally arise from governmental activities. Most often, they result from expenditures of governmental fund financial resources. They should not be reported as assets in governmental funds but should be reported in the governmental activities column in the government-wide financial statements.

900 General long-term liabilities - the unmatured principal of bonds, warrants, notes, or other forms of noncurrent or long-term general obligation indebtedness. General long-term debt is not limited to liabilities arising from debt issuances, but may also include noncurrent liabilities on lease-purchase agreements and other commitments that are not current liabilities properly recorded in governmental funds. General long-term liabilities should not be reported as liabilities in governmental funds, but should be reported in the governmental activities column in the government wide statement of net assets.

MEASUREMENT FOCUS BASIS OF ACCOUNTING (MFBA)

Traditionally, governments have used essentially the same accounting as private-sector businesses for their proprietary funds (enterprise and internal service funds) and similar trust funds (nonexpendable and pension trust funds). In both cases, the measurement focus of the operating statement has been on the *changes in economic resources* (changes in total net assets). Such changes have been recognized as soon as the underlying event or transaction has occurred, regardless of the timing of the related cash flow – the accrual basis of accounting. Thus, under GASB 34, proprietary funds (enterprise and internal service funds) and fiduciary funds recognize revenues as soon as they are earned and expenses as soon as a liability is incurred, just like private-sector businesses.

Governments have always taken a very different approach, however, in accounting for their governmental funds and expendable trust funds. The measurement focus here has been on *changes in current financial resources*. Additionally, changes in current financial resources have only been recognized to the extent that they normally are expected to have an impact upon near-term cash flows (modified accrual basis of accounting). Therefore, in addition to being earned, the inflows of expendable financial resources must also be available to pay for current period liabilities before it can be recognized as revenue. Likewise, in several cases (interest payable, compensated absences) no expenditure is recognized in a governmental fund for future outflows of financial resources that does not represent a use of current financial resources. This unique MFBA for governmental funds is reminiscent of fund accounting's historical link with checkbook accounting (funds originally developed out of separate checking accounts) and is consistent with the near-term financing focus that typically characterizes a government's operating budget.

Private-sector businesses adopt budgets, as do state and local governments. However, the role of the budget in public sector is unique. In the private-sector a budget is simply a financial plan, whereas in the public sector it plays a critical role in the system of checks and balances between the executive and legislative branches of government. Indeed, so important is the budget in the world of public-sector finance that demonstrating compliance with the appropriated budget has traditionally been an integral part of governmental financial reporting in the form of a mandated budget-to-actual comparison statement. Additional details as to how the budgetary comparison statements should be presented will be discussed at a later point.

Governments, unlike businesses, do not ordinarily provide services as a means to an end (i.e., profit), but rather as an end in themselves. In principle then, governments make their financial plans by first determining the types and levels of services they need or wish to provide, and then determining how these services are to be financed. Some services are partially financed from sources outside the government itself (i.e., charges for services, grants and contributions). In that case, a government will naturally wish to isolate and focus its attention on the portion of the cost of services that it will need to finance from its own resources. The "net program expense" format mandated by GASB 34 is designed precisely to reflect this unique governmental perspective.

PROGRAM REVENUES - Under the net program cost format, program expenses are netted against program revenues. Program revenues include the following:

? amounts received from those who purchase, use or directly benefit from a program; (extension, recreation, airports, etc) Charges for services should also include revenues from licenses and permits (they directly benefit by paying for the privilege), liquor licenses and building permits.

? amounts received from parties outside the school's citizenry (e.g., grants and contributions) that are restricted to one or more specific programs.

? earnings on investments that are legally restricted for a specific program

Charges for <u>services</u> should be reported separately from grants and contributions. Likewise, <u>operating</u> grants and contributions should be reported separately from <u>capital</u> grants and contributions. A grant or contribution that may be used for either operating or capital purposes should be treated as an operating grant or contribution.

Fines and forfeitures should be reported as program revenues. As a rule, charges for services should be reported as a program revenue of the function that generates them. In the case of fines and forfeits, one function (e.g., police, health department) often will issue a citation for an alleged legal or regulatory infraction, which is then subject to adjudication by the courts. Another way to look at reporting fines with the police department is that if there were no police department there would be no fines.

To qualify as program revenue, a <u>grant</u> or contribution must be restricted to one or more specific functions. In the case of multi-purpose grants, the amount associated with each particular function must be specified either in the grant contract or in the underlying application form. However, multi-purpose grants of the reimbursement variety always will meet the test of restriction because such a grant, for accounting and financial reporting purposes, is only considered to occur when all eligibility requirements have been met (including the incurrence of qualifying expenditures in a particular function).

GENERAL REVENUES – All revenues that do not qualify as program revenues should be reported as general revenues. General revenues are to be presented immediately below the totals for "net (expense) revenue and changes in net assets."

All taxes, even those that are levied for a specific purpose, are general revenues and should be reported by type of tax –for example, property taxes and sales taxes. All other nontax revenues that do not meet the criteria to be reported as program revenues should also be reported as general revenues.

General revenues are not always discretionary revenues. For example, even though motor vehicle revenues cannot be used for other than "road" purposes, they are still general revenues. Program revenues derive directly from the program itself or from parties outside the school's taxpayers or citizenry, as a whole; they reduce the net cost of the function to be financed from the government's general revenues. Motor vehicle revenues do not derive directly from the public works program itself, but rather they are restricted general revenues provided by law to finance the cost of specific programs.

The gain or loss on the sale of a fixed asset should be netted into general revenues as a miscellaneous revenue. Consideration should also be given to reporting the sale of a fixed asset as a special or extraordinary item if it fits the relevant criteria.

GASB 31 provides us with a minor change in how interest earned is to be reported. Currently under state law, interest earned is receipted DIRECTLY to the General Fund or to the respective funds.

GASB 31 states the following, "If, however, the investment income is assigned to another fund for … management decision – the income should be recognized in the fund that reports the investments. The transfer of the income to the recipient fund should be reported as an operating transfer." So if the governing body decides that investment income should all go to the General Fund, the interest earned must be first placed into the fund that earned the income and then transferred to the General Fund by operating transfer to meet the boards intent.

Interest earned by Agency Funds may be placed directly into the General Fund. This exception is allowed because Agency Funds do not record any revenues.

Contributions to permanent fund principal are to be reported as a separate revenue line in the general revenue section of the government-wide statement of activities. Contributions will be reported as revenues and should be reported separately, after nonoperating revenues and expenses, on the statement of revenues, expenses and changes in fund net assets. As a result, capital contributions will no longer be displayed as a separate component of net assets.

REPORTING EXPENSES BY FUNCTION – GASB 34 mandates that governments report their activities at least by function. That is to say, in the case of governmental activities, the level of detail required is that currently found in the governmental fund operating statement (e.g., "general government," "public safety," "public works"). For business-type activities, each segment (enterprise fund) is considered to be a function. (water, sewer, liquor, electric). Each function should report all expenses that are clearly identified with it (i.e., direct expenses). Direct expenses include <u>depreciation</u> related to capital assets that can be specifically identified with a given function. This means that equipment should be sorted by function with the respective depreciation expense coded to each related function.

<u>Interest</u> on long-term debt is NOT a direct expense and should be reported as a separate function.

Depreciation expense that does not qualify as a direct cost (primarily buildings) should be reported as a separate line item in its own right. If a separate line is used, it should be made clear on the face of the statement that only unallocated amounts are included in that line.

Depreciation on infrastructure assets should be reported as a direct expense of the function normally associated with the acquisition and maintenance of infrastructure, or alternatively, as a separate line item.

Depreciation expense will play a key role in the new government-wide statement of activities, consistent with the GASB's adoption of the economic resources measurement focus and the accrual basis of accounting for government-wide reporting.

Along with the change in reporting of the general fixed assets account group comes another change required by GASB 34, that of capital asset depreciation and infrastructure reporting. Accountants have used the term "infrastructure" to refer to assets that are immovable and of value only to the government (roads, bridges, dams). Under the current financial reporting model, state or local governments have not been required to report general infrastructure assets in their financial statements. However, the economic resources measurement focus and the accrual basis of accounting will be used in the future to report governmental activities in the government-wide financial statements. Under GASB 34 governments are to capitalize general infrastructure at their historical cost or estimated historical cost. Governments are required to capitalize all future infrastructure acquisitions, renovations, restorations, or improvements from the date of implementation of GASB 34 (prospective reporting).

Although state and local governments traditionally have reported general capital assets in their financial statements, they have not depreciated those assets. Once again, the move to the economic resources measurement focus and the accrual basis of accounting will substantially change traditional practice. Governments will be required under the new financial reporting model to report depreciation expense for all of their capital assets, including general infrastructure assets discussed above.

Capital assets now reported in the general fixed assets account group will henceforth be reported in the "governmental activities" column of the government-wide statement of net assets. Governments also will be required to report general infrastructure assets in this same column, even though the reporting of general infrastructure assets is not required under current GAAP.

Just as the assets section for "governmental activities" of the new government-wide statement of net assets is to include items currently reported in the general fixed asset account group, so too, the liability section of the same statement will include all liabilities currently reported in the general long-term debt account group. This means that bond issues, sick and annual leave and other long-term liabilities will be pulled in and reported with governmental activities.

Another change, which will take place, is the term "quasi-external transactions" will no longer be used. Rather, GASB 34 refers to this form of internal activity as "reciprocal interfund activity". There are two types of reciprocal interfund activity - interfund loans and interfund service provided and used. Items previously reported as quasi-external transactions meet the definition of "interfund services provided and used," and are reported as if they were external transactions, as i.e., revenues and expenditures/expenses.

Previously, transfers were separately reported as either operating or residual equity. Under the provisions of GASB 34, there will be a single "transfers" category that will encompass both type of transfers.